

# Business & Economie

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## AUTHORS

Valeriu Prohnițchi  
 Alex Oprunenco  
 Alexandru Gamanjii  
 Ana Popa

## EXPERT-GRUP

web: [www.expert-grup.org](http://www.expert-grup.org)  
 email: [info@expert-grup.org](mailto:info@expert-grup.org)  
 adress: Str. A. Russo, 1, of. 804, Chișinău,  
 MD-2068, Republic of Moldova  
 tel./fax: /37322/ 43-82-80  
 tel. /37322/ 43-82-45

## Summary

In July the **regulatory framework** was marked by several key evolutions. The publication of study “The costs of developing business 2007” pointed out a progress in simplification of company registration procedure, but also a stagnation in authorizing and licensing of activities. At the same time, the Government adopted a controversial decision to create a working group for monitoring the “strategic” foreign investments. Persisting in creation of different working groups, the Government delays the really important reforms, to begin with the regulatory reform. For this reason, the Parliament had to postpone the enactment of the Law on Basic Principles Regulating Entrepreneurial Activity for several months. The new Law on combating and preventing money laundering and terrorism financing, adopted by the parliament in July, could enter in juridical collisions with provisions of the laws on fiscal amnesty and capital legalization. Other important evolution is the adoption of Law on industrial parks that generates too optimistic expectations to the Government. Although this law was designed to ensure an accelerated development of the localities and regions, it offers to the local public authorities a marginal role in constituting and monitoring the parks’ activity.

The statistical data for July showed that the **industry** has almost completely recovered after the 16-months recession. The main branches which moved the industry out of recession are the meat processing, textiles, beverages, paper and printing industries. A less noticed evolution until recently, but increasingly evident, is the accelerated growth of the equipment and precision instruments industry. Throughout the last years, it was a target for important foreign investments, mainly Russian. The strong growth is determined by the presence of well-qualified human resources and the constant external demand for production. The industrial recession caused important changes in the sector. The most important is the reduction of the weight of alcoholic production in the total industrial output, from 15% in June 2006 to 8% in June 2007. Two important branches – tobacco production and equipment and machinery industry – are in a prolonged stagnation, although crisis in commercial relations with Russia did not directly affect them. Although there can be noticed some timid attempts for resuming the growth of the alcoholic drinks industry, they are comparable to the situation from the middle of 2006, when the crisis reached its peak. The recovery of the branch to the 2005 year level of production is less probable in the next 2-3 years. However, it will depend on the producers’ possibilities to consolidate their production capacities, to explore and

maintain their positions on new markets. The complete return to Russian market is impossible, and even the regaining of its small segments would require rebranding of Moldovan products and huge advertisement and public communication costs. But the image of the Moldovan wines on the Russian market was almost irrevocably compromised during the last two years.

**Agriculture** is strongly influenced by drought. Such a destructive impact of weather on agriculture has never been registered in the recent history of Moldova. Although the recession rate reached “only” 5% in the first half of 2007, the duplication or triplication of this indicator it is likely until the end of the year. Direct losses borne by agricultural producers mount above 1 billion USD and are supplemented by additional costs borne by adjacent branches, namely meat processing and dairy industries. The drought mostly affected the rural population incomes. Considering that this category has traditionally quite low incomes, its purchasing power is also undermined by the significant rise of prices, including for non-home produced food. In order to ensure a minimal level of personal security and in expectation of higher prices, the peasants refuse to sell the wheat crop. Although the authorities declare that the country’s food security is not jeopardized, the aid appeals to the international community launched by the Government at the beginning of August are very conclusive. In this situation, the authorities found two intervention tools. Firstly, the Government “advised” the producers not to rise prices for wheat, flour and bread. Secondly, by a President directive was created a state commission for developing a sustainable development strategy for agriculture. These two findings seem doubtful while the agricultural sector requires an immediate and consistent financial aid.

The **services sector** maintains its ascending trend due to the increased remittances flows and wages. The retail sales grew by 14% in the first half of 2007, and the volume of services rendered to the population by more than 6%. However, there can be noticed a deceleration of the ascending trend that could be explained by citizens’ negative expectations regarding the short-term economic perspectives and their wish to put aside a bigger amount of their incomes. On the telecommunications market, the competition for clients among 4 present operators is on the heat and it is likely to become even fiercer in the next months.

In July, after a semester of 3,9% inflation rate, the **prices rose** more rapidly than in the previous months,

registering 1.1%: 1.6% for food, 1.1% for non-food goods and 0.4% for services. As of August, the tariff for final electricity consumers increased due to both rise of price for delivering the Ukrainian electricity up to 3US cents for 1 kWt/h and, for electricity produced by Moldovan CET-urile on average by 1.85 times. The price for Ukrainian electricity will continue to rise up to 3.6US cents for 1kWt/h until the end of 2007. Thus, the rise of prices in the second semester will hasten as compared to the first semester. This will complicate the maintenance of the inflation rate under 10% as the Government and the National Bank planned.

In January-June the **real wages** grew by 11%, boosted by education, health and public administration sectors. Traditionally, the wages remain high and even increase further in the constructions sector. The wages within the energy and financial sectors slightly declined, but these evolutions are not alarming considering that the wages in these sectors are much higher than the national average salary. For the rest of sectors, the wages vary around the minimum consumption budget, while in the agriculture they are twice lower. It is obvious that the statistically registered increase of wages is not enough forceful for qualified personnel that emigrates from Moldova as massively as in the previous years. At the same time, a group of activities, namely the financial, real estate and business consultancy sectors, where the wages become more competitive come into view. An important role in this change has the externally financed projects and programs that hire local qualified personnel.

The plan of revenues to the **state budget** for January-July 2007 was executed in proportion of 102.3%. Therefore, amendments to the State Budget Law on increasing the expenditures for agriculture, the fund for subsidizing agricultural producers and the Ministry of Agriculture and Processing Industry were introduced. The expenditures were executed only in proportion of 85.3% of the planned one. In July, the Medium term Expenditure Framework for 2008-2010 was approved. It stipulates important changes in the state fiscal policy for both juridical persons by applying the null taxation quota for the reinvested taxes, and for physical persons by applying a double-scale taxation grid to their income starting with 2008. Moreover, the main parameters of the 2008 State Budget Law were established.

As EXPERT-GRUP anticipated in previous BER editions, the Administration Council of the National Bank of Moldova (NBM) did not modify the **monetary policy** tools at its meeting in July 2007. The last cut in interest rates was made in April 2007. Nevertheless, working in an increasingly risky inflationist environment, the commercial banks hesitated to follow the NBM example

and did not reduce the interest rates. On the contrary, the general trend for 2007 is for increasing both attracted resources and offered credits. The leu appreciation, evident for 2007, is to a certain extent diluting the inflationary pressures and increasing the official reserve assets. By the end of 2007, the target-level of 1 billion USD will be probably reached. At the same time, the leu appreciation on the background of prices rise undermines the purchasing power of a significant segment of the population that depends on the remittances, and reduces the level of the economy competitiveness.

In the **banking system** the average interest rates to the attracted deposits increased throughout the first semester and in June registered 15.49% on deposits in MDL and 5.96% on deposits in foreign currency. The average interest rate on offered credits rose slower, registering in June 18.98% on credits in MDL and 11.01% on credits in foreign currency. These trends run counter to the Government objectives to reduce the interest rates on credits. At the same time, the intervention tools are quite restricted, if even existent. The NBM will be unable to reverse this tendency in the short-term, since the NBM main objective is to control inflation. In this regard, the more accessible bank credits will only nourish the inflation.

Despite the inflation growth, the interest rate on T-bonds continues to decline in real terms. This will diminish the attractiveness of such **financial market** tools in the long term. On the contrary, the interest rates on long-term bonds continue to grow. Such trends are a result of the demand fluctuation for the treasury bills. The banks seem to be more interested in investing their resources in short-term bonds and less in long-maturity bonds. Other distinctive element of the financial market is the exchange rate. The depreciation trend of the US dollar against the Moldovan leu has intensified in July-August. Both the foreign currency inflows from individuals and large foreign investments fostered the Moldovan leu appreciation. At the same time, Moldova received external credits in several installments that influenced the situation on the foreign exchange market. Other factors that cheer the leu appreciation come from Russia, the main Moldova's trade partner, where the ruble has constantly and significantly appreciated during 2007.

Moldova's **foreign trade** was marked by several major evolutions in the first semester of 2007. On the one hand, the trade deficit continued to grow. It reached 1007.3 mln. USD at the end of June, lifting up by 45% as compared to 2006. On the other hand, the data show that the European Union became the main export

destination for Moldovan producers. The “geographical” restructuring goes along with the reshuffle of exported goods; the textiles became the main export item to the detriment of agro-food exports. The revitalization of agro-food exports will require the authorities’ and companies’ efforts in ensuring the quality, certifying the exported goods and increasing their competitiveness. The main component of this category - wine exports - apparently has better perspectives to return to Russian market. However, this return will not solve all problems within the sector. At the same time, both the interests of the Moldovan wine-making companies and the Russian partner companies and consumers, would require a higher level of transparency and predictability regarding this “sensitive” subject.

The **oil** price for WTI brand recorded 75USD/barrel during July, indicating a strong ascending trend. This evolution was mold by a vigorous growth of the consumption against the background of a stable demand. The International Energy Agency estimates that the world oil consumption will increase speedier in the next years than expected. At the same time, the vigorous rise of prices could undermine the prospects for the world economy.

The 07/08 **wheat** crop forecast continues to be negatively affected by unfavorable weather, especially in South-eastern Europe and Canada. On the other hand, the crop in Kazakhstan, China and India alleviate these negative tendencies. Nevertheless, the world wheat ending stocks have the lowest volume in 28 years.

The **euro-dollar** exchange rate registered contradictory evolutions in July. The first half of July was marked by notable dollar depreciation against the euro. The dollar depreciation stemmed from negative trends in the American economy and the economic optimism in Europe. In the second half of July, the dollar managed to strengthen against the background of increasing turmoil on world markets. However, the gloomy expectations on American economy prospects (mainly, the situation in the real estate sector) has again determined the dollar depreciation at the beginning of August. The majority of experts anticipate the dollar-euro pair to evolve to 1.4 USD/EUR in the next future.

During the first semester, the **Russian** economy grew by 7.8% comparing to the first semester in 2006. The growth is supported by investments demand, constructions and industry. The consumption demand remains high, particularly for imports.

The **Ukrainian** economy maintains its perky growth due to private consumption and exports. The robust

economic growth determined the revision of the economic growth forecast. In the future, the growth prospects for the Ukrainian economy will depend on several factors: the conjuncture on the metal and chemical products markets, the evolution of prices for natural gas, political evolutions etc.

The economic prospects for **European Union** remain good, and are supported by demand for consumption and investments. So far, the euro appreciation has a minor impact on exports; the euro-zone recorded a trade surplus of 1.7 billion euro in May 2007. High consumer and producer confidence conveys to upping industrial orders, unemployment decline and strong private consumption. The economic optimism will persist in the near future.

The **Romanian** economy continues its ascending trend sustained by positive industry dynamics (except the processing industry), retail trade and services. At the same time, the managers expect positive evolutions for all main sectors of the economy during July - September. The strong economic growth along with Romania's joining the EU, made Romania attractive for regional investment funds. Their capital supply soared exponentially in 2006.



## Regulatory framework

Among the most important events in the regulatory area happened in July, was the presentation of study on the Costs for Developing Business. This study shows that time and money costs for launching a business continue to fell in 2007, although still serious problems exist in receiving the authorizations. A very important issue is the big number of controls conducted, inclusively by bodies with a questionable competence. Especially, it is the police case, identified by the above-mentioned study as an omnipresent controller.

It is noteworthy that on 18 July, the Government decided to create a working group for monitoring the “strategic” foreign investments inflows and the investments-related transactions. This decision seems dubious for several reasons. Firstly, it is unclear what the investments “monitoring” mean and how “the monitoring of the direct strategic foreign investments directed to the country’s regions” will take place. Secondly, it is not clear how and why the working group should analyze „the influence of direct strategic foreign investments on macroeconomical indicators”. The oddest thing is that the group “will coordinate the investment processes with the central and local public administration”. This decision is extremely doubtful in regard to the liberalization of the business framework and creation of proper conditions for attracting foreign investments. Moreover, the term of “strategic investments” is not regulated by neither legislative nor normative act.

In July, the Parliament adopted the new Law on preventing and combating money laundering and terrorism financing. The most important provision of this law sets the obligation of reporting entities (financial institutions, exchange offices, professional real estate agents, insurance companies, casinos and entertainment places with slot-machines, advocates and notaries etc.) to report all peculiar transactions. Both unitary and multiple transactions exceeding the threshold of 500 thousands lei (accumulated in 30 days for multiple transactions) are qualified as peculiar. The law analysis found some juridical collisions that could occur when the reporting entities will apply the above-mentioned procedure to the individuals legalizing their capital.

In July was also adopted the law on industrial parks that generated too optimistic expectations to the Government. The Government declared that regional development and the reduction of discrepancies between Chisinau and other regions are the aim of

this law. At the same time, the role of local public authorities in constituting and monitoring the parks’ activity is marginal, although the local and regional collectivities are pointed out as the main beneficiaries of the positive effects of industrial parks.

The Parliament also voted the amendments to the Law on Basic Principles Regulating Entrepreneurial Activity.<sup>1</sup> The reason behind these amendments was to extend the implementation of regulatory reform from 11 August to 30 November 2007. The Parliament presented several arguments in favor of the extension of time, such as uncompleted process of transposing the Law principles into national legislation and elimination of juridical conflicts and confusions. However, it seems that the real reason behind this backwardness is the strong opposition of some governmental institutions and ministries to amending some laws. As a result of these pressures, the Government proposed to the Parliament the draft law on Basic Principles Regulating Entrepreneurial Activity with one month delay (on 20 June), and the parliament rejected it. One of the reasons behind the rejection is the lack of harmony between the proposed legislative amendments and their trade-off versions discussed and agreed by the businessmen at public debates. It is noteworthy that during the regulatory reform implementation, the Government has repeatedly broken the schedule of presenting the informative notes and legislative proposals. Especially this attitude has finally undermined the rapid implementation of the reform, so expected by the private sector. In a normal country, such failures would motive the Parliament to penalize the Government.

## Industry and constructions

July was marked by the end of industrial recession stemmed from the barriers imposed by Russia to alcoholic imports. The recession of the industrial branches hit by trade barriers has been already counteracted by strong ascension of other industrial branches. In the first semester the total industrial output summed 11.8 billion lei, practically similar to the level registered in January-June 2006 (Fig.1).

The meat processing was one of the branches that significantly contributed in pulling the industry out recession (+22% as compared to the first semester 2006). This dynamics derived from the opening of some “windows” of export on Russian and Ukrainian markets and from increasing consumption on the internal market. Nevertheless, there are some doubts

<sup>1</sup> Law no.235-XVI of 20 July 2006.

about the short-term prospects of the meat processing branch. It has strong connections with the agricultural sector that seems to register in 2007 a dramatic drop of production, inclusively in the zootechnical sector.

**Figure 1 Industrial output growth, cumulative from the beginning of 2007, %**



Source: NBS

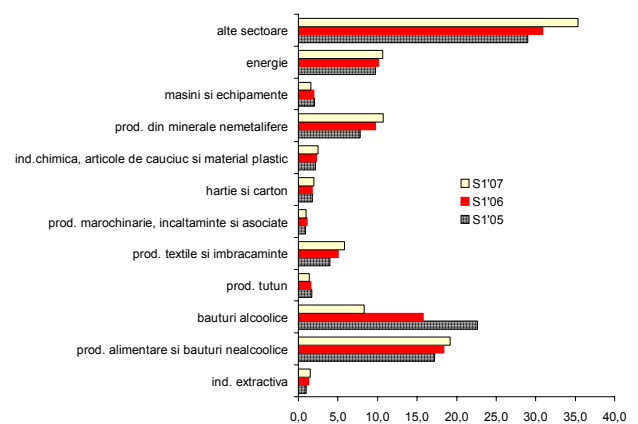
The textile production grew by 10%, favored by the long-term contracts of local companies with their European partners, and recently discovered new small and medium capacities of production.

The unusual hot weather in this summer has determined a high demand for beverages that lifted the production by 38%. The carton and paper production soared by 20%, and the publishing production by 5%, both influenced, beside other factors, by huge orders for electoral advertisement. The glass, cement and tiles production rose by 16%, while the production of finite metal products by 27%. In both cases the ascending pace slowed down, which is correlated with the slower growth in constructions sector. It is also remarkable the really spectacular growth of the equipment and precision instruments branch, that doubled its real production in the first semester of 2007. This fulminating dynamics is explained by the foreign investments (mainly Russian capital) in this branch and the increasing foreign demand for production (flaw detectors and other indestructible control equipment, diagnosing equipment for telecommunications, military technologies etc.).

The above-mentioned branches will ensure the industry's growth for the next months. Nevertheless, the recent industrial recession will not pass without consequences. The recovery of the aggregated level

of production was followed by essential structural changes in the industrial sector (Fig.2). The most significant change is the decline of alcoholic products weight of in the total industrial output from 23% in the first semester of 2005, to 15% in 2006 and 8% in 2007. Both machinery and equipment construction and tobacco production have also significantly reduced their weight in the total industrial output. This decline is not linked to the external trade barriers, but rather to the state-controlled enterprises that dominate these branches unable at present to adapt for functioning efficiently in an open economy.

**Figure 2 Structural changes in industry, % of total**



Note: S – half-year

Source: NBS

These tendencies will endure throughout 2007. However, the importance of the food industry, textiles, constructions materials and other small branches will increase. It is also likely a moderate growth of the alcoholic drinks industry in the long run. This will be possible through strengthening the production capacities of the winemaking sector along penetrating the niches on new markets. The efficient exploitation of the Romanian market proves the existence of a potential. On regard to the Russian market, it is possible the recovering of some small market segments in the long run, but only through a qualitative rebranding of Moldovan products and huge advertisement and public communication costs.

## Agriculture

The drought inflicted immense losses on the agriculture in July. The total losses reached 1 billion USD<sup>2</sup>, inclusively 1 billion lei – for cereal crops and vegetables, 1.7 billion lei – for meat production, 1.4

<sup>2</sup> According to the data presented at the Government meeting of July 31, 2007.

billion lei – for dairy production<sup>3</sup>. Other drought's effects (e.g. the impact on processing industry) were not considered yet, but these will be also huge.

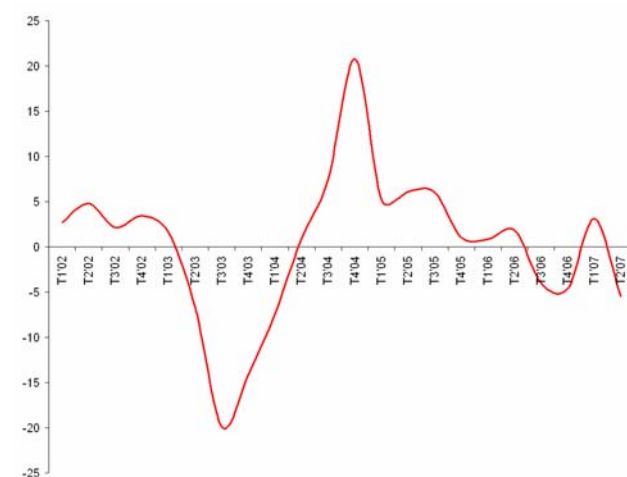
The calamities have considerably affected the young vineyards, fruit plantations and autumn crops either. At the same time, the irrigation capabilities have been strongly disturbed by the degradation of hydrological regime. After the Government earmarked additional 5 mln lei to the initial sum of 7 mln lei allocated for irrigation, the irrigation of almost 50 thousands ha was done. The Government has also promised an additional allocation of 10 mln lei for subsidizing the electricity for repeated land irrigation. It is clear that the real irrigation requirements are much higher. According to some estimation, the agriculture needs almost 199 thousands ha of irrigated land in order to reduce the drought risks. The Ministry of Agriculture and Processing Industry plans to reach this area by 2015. In this regard, almost 900 mln lei should be earmarked. However, still remains unclear how the farmers' financial power will allow them to sign contracts for irrigation and how will be solved the technical problems that could emerge because of the plots fragmentation and dispersion.

The official statistics estimates the volume of sold agricultural production to near 3127 mln lei in January-June, or 94.6% (in prices) as compared to January-June 2006 (Fig.3).<sup>4</sup> Obviously, in the current drought conditions, these data do not catch the real situation that started to become visible at the beginning of June 2007. By all appearances, the final 2007 year data would be worse. Thus, the cereals and vegetables crop has amounted 620 thousands tons, lesser by 48% than the planned volume, and the wheat crop has amounted around 430 thousands tons, lesser by 40% than planned. Although other crops were less affected, they are not enough to counteract the cereals and vegetables losses.

The drought consequences hit the incomes of population, but the rural population is the most affected. On the one hand their real incomes shrank substantially, while on the other hand the prices for dairy products rose by 9-10% and for bread production by 30%. The authorities declared that the country's food security is "stable" and there are no grounds for a crisis in supplying the country with wheat and flour. Nevertheless, the aid appeal

launched by the Government to the international community proves that the situation is not so "stable". Not accidentally, the offer from the peasant households was almost inexistent at the previous tenders for purchasing cereals for the state reserve.

**Figure 3 Growth of agricultural production, cumulative from the beginning of 2007, %**



Note: T1 – first quarter, T2 – second quarter etc.

Source: NBS

In order to avoid the speculation of prices for wheat, flour, bread and bread products and to supply the available stocks of wheat, flour, barley and forage on internal market, the imports of the above-mentioned products were exempted from customs duty and VAT. At the same time, the authorities declared that the wheat prices have stabilized and even declined on the world market. This represents a misleading; as from the beginning of 2007 the wheat prices rose by 35% in Europe and by 30% in USA. With regard to the assertion that prices for bread will remain unchanged, the reality is that in some country's regions the prices have already risen by 30%. The only exception is Chisinau, where the Government controls S.A. „Franzeluța”. It is noteworthy that when this joint-stock company was compelled to maintain the bread prices unchanged in 2003, it lost 40 mln lei. This situation could repeat this year too, if the company does not receive subsidies. The apparently optimistic news is that the cereals producers will be cheered up to sell wheat surpluses for supplying the state reserve to a price of 3.2 lei for a kilogram. However, previously organized tenders show that this price is not attractive any more for producers. At the same time, the authorities are ready to subsidize the purchasing of fertilizers and phytosanitary products, by additional 29 mln lei to the planned 45 mln lei.

<sup>3</sup> According to estimations of the Ministry of Agriculture and Processing Industry.

<sup>4</sup> A concise information on the social-economic situation of Moldova in January-June, 2007, NBS.



On 30 July, the president put forward a proposal on developing a sustainable development strategy for agriculture. In this regard, a special state commission has been already constituted. It is difficult to believe that developing such strategy represents a short-term priority in rescuing the agricultural sector. At present, the agriculture development is stated as priority in a set of strategic documents: the Development Strategy for the Agro-food Processing Sector for 2006-2015, Economic Growth and Poverty Reduction Strategy, National Program „Moldovan Village”, the draft of the National Development Plan etc. Not supported financially, the majority of strategies and programs rather have a declarative character. Considering that the current situation is more severe, there is a real chance that the new strategy will enlarge the group of other ineffective strategies.

## Services

The services sector maintains its ascending trend stemmed from the increasing volume of remittances and wages. In January-June 2007 the goods retail sales rose by 15.4% in private ventures and by 13.6% - in joint ventures with foreign capital as compared to (as compared to January-June 2006), opposed to the good retail sales declined in the private-public joint ventures by 9.3% in real terms.

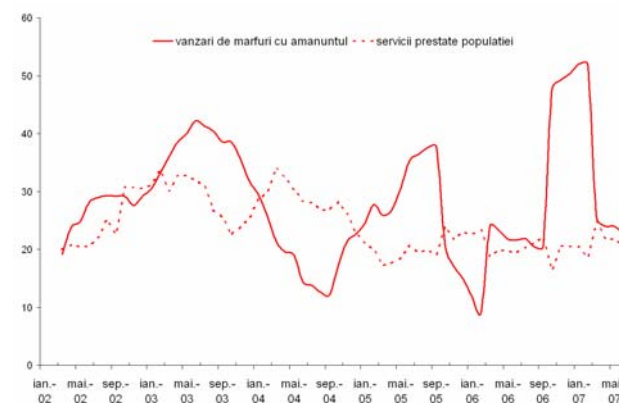
The volume of services rendered to the population increased by 6.1% in real terms. In particular, the public institutions rendered almost 40% of total services (by 3.7% higher than in January-June 2006), the private institutions - 33.4% (by 16.4% higher than in January-June 2007) and the joint institutions - 26.6% (by 3.2% lower in real terms for joint institutions with foreign capital).

Namely, we find a high growing pace for retails sales and services, while the consumption continues to be mostly financed from abroad, not by real incomes. At the same time, a minor slow down of the sales growth could be noticed (Fig. 4). This trend differs from Moldova's seasonal patterns. It is determined by the less optimistic short-term economic expectations of the population and the tendency to put the major part of incomes aside.

Despite the pessimistic expectations of the population, the telecommunication services continue to develop spectacularly. On 4 July, the company “Orange” informed that crossed 1 mln clients-threshold. This also happened due to the rebranding what allowed the registration of 74400 new clients in the period 25 April - 4 July 2007. Other operators have registered notable evolutions either, and as a

result the services become more varied and available financially. These evolutions emerged against the background of intensifying competition in the telecommunication sector. The competition will become fiercer in autumn, when huge investments from the company Eventis-Mobile are expected.

**Figure 4 Growth of retail sales and services rendered to the population, cumulative to the beginning of 2007, %**



Source: NBS

July was also marked by a conflict between the Civil Aviation Administration of the Republic of Moldova (SAA) and several air carriers. On 21 July, the Court of Appeal annulled the SAA order prohibiting the exploitation of airplanes in Afghanistan and Iraq. Nevertheless, other SAA order revoking the air carriers' exploitation certificates remains valid. If this decision is not revised in the next future, the grieved companies will go to the Court of Appeal again. The major problem is that the airplanes are not currently allowed to take off and stay in different airports, paying high taxes. If they do not receive the exploitation certificates, their stay will not be possible anymore. In this regard, the single solution will be to transfer the airplanes in the property of other states' companies.

## Prices

After a semester with a relatively low cumulative inflation – 3.9%, in July, the prices went up quicker than any previous months of this year. According to the data offered by the National Bureau of Statistics the average consumer prices went up by 1.1 %. At the same time, the cumulative inflation for the last year increased by 12% against 10% in June. The agricultural products registered the highest increase in prices –1.6% and namely the wheat flour and pastries that led to the bread markup with 4.7% against the previous month. The prices for dietetic

eggs increased by 32, 2%. The prices for vegetables and fruits decreased with an average of 3,8% and 2, 7% respectively.

**Table 1. Inflation rates, by moth, %**

	Apr 2007	May 2007	June 2007	July 2007
Consumer price index	1,0	0,9	0,0	1,1
Food products	2,0	1,6	-1,3	1,6
Non-food products	0,5	0,6	0,7	1,1
Services	0,2	0,4	0,2	0,4
Industrial producers' price index	0,2	0,8	0,0	

Source: BNS

The most significant increase in prices were registered for the non-food products and especially for the fuel (+3,4%). This negatively influenced the prices for passengers' transportation. Particularly, the prices for the railroad passengers' transportation increased by 3,3%.

A low inflation rate was kept, in the 1st semester of this year, due to the sterilization operations of cash excess by the NBM. At the same time, with the purpose of reducing the monthly inflation rate, the base rate of the NBM, applied to re-finance the banks through REPO operations, was kept at the level of 13,5% during the 2nd quarter of the year 2007

A higher inflation rate is expected in the second part of the year, as a result of adverse weather conditions. Another risk that will lead to an increase in prices in the 2nd semester of this year is the increase of the prices for energy resources. The delivery price of the electric energy from Ukraine to Moldova has increased from 2,6 to 3 US cents per 1 kWt/hour. Therefore, a gradual increase of 0,1 cents per month for 1 kWt/hour is foreseen until the end of 2007. The energy rates generated by the Moldova CET, went up with an average of 1,85 times. The new rates for the electric energy for the final consumers have already been adopted and will be valid till 31 December 2007. According to the decision of the National Agency for Energy Regulations, regarding the new established rates for the electric energy as of 31 June 2007, the rate for the electric energy for the final consumers of RED Chisinau, RED Centre, and RED South have been increased by 21,3% - from 0,78 lei to 0,96 lei per 1 kWt/hour. The energy rate for the final consumers of RED North and North-West has increased by 44,3% - from 0,7 lei to 1,01 lei per 1 kWt/hour.

The Government forecasts an inflation rate up to 10% for the year 2007, whereas the IMF forecasts are more pessimistic – 10,5%. The price rate of growth from the beginning of the 2nd semester and the above identified risks – drought and the increase of energy prices – will make difficult the maintenance of an inflation rate under 10%. At the moment, the Government is trying to ensure control over the prices, even through administrative tools and their effects, in the best case, will be null. In particular, the Government has threatened to sanction those producers that will increase „unjustified” the prices for wheat, flour and bakery products.

## Labour Market

In January – June 2007 the real salary increased by 11%, the level reached in June constituted 2221 MDL (182 USD). The average salary in the real sector accounted for 2236 MDL, in the budget sector - 2192 MDL, showing an increase of 0,45% and, respectively – 28,79% more than in May.

The most significant increases of nominal salaries compared to May were registered in education - 47%, medicine – 16% and in public administration – 8% (as a result of salary increase in the budgetary sphere, produced by the Government). In the field of fishery, the salaries accounted an increase of 23%, as a result of income increase of sold fishery. In the field of hotel and restaurant services, the salaries were increased by 7,7% due to an increase in customers and prices. The beverages industry also accounted an increase in salaries by 7,5% due to customers' and prices' growth in summer time. Not surprisingly, but the salaries have been increased even in the construction sector (+4,5%) due to the ongoing boom of this sector.

However, some sectors have registered lower nominal salaries compared to May: in the sectors of energy, heating, gas, and water supply with 5,1%, and the financial sector with 5,4%. In the first case the explanation would be that the income in the energy sector decreases in summer time. As for the financial activities, the retribution in the sector probably has gone beyond the „tolerance level”, due to the existing reserves for these wage cuts. Unfortunately, the agricultural sector continues to be the lowest paid sector - 1023 MDL, practically twice less than the Minimum Consumer Budget.

The analysis of the labour retribution in January – June 2007 allows us to conclude that, if taken into account these increases, the average salary quantum in the real and the budgetary sector swings

around the size of the Minimum Consumer Budget that is the minimum cash amount to ensure the basic needs of the employees. However, this minimum could be affected, as in July the prices for dairy products were increased by 9%, bread up to 30%, eggs – 30-37%. Starting with August 1, (as of ANRE decision) the electric energy increased up to 20%. Let us not forget that this is just the first wave of markups, as others may follow if the drought proves to have long lasting effects and be harmful for the autumn harvest.

In this situation the labour market faces an acute deficit of qualified labour force. Unfortunately, the Government seems not to be really concerned about these issues, although the alerts that came from the industry, constriction and energy sectors are quiet alarming. On the background of the intense labour migration, the authorities' policies to improve the quality of education and training of the young specialists, as well as increase the salaries does not materialize into concrete results. The lack of qualitative labour force is a hindrance to serious flows of foreign investments. On the other side, the candidates' requirements grow: higher salaries (more and more often the amount of 500 USD per month can be heard), flexible working program etc. If companies cannot face these requirements, the candidates more often start refusing the offers. This tendency is also caused by Moldova's neighborhood with EU. Being aware of EU salaries more specialists would prefer the migration (both legal and illegal) rather than working for a miserable salary.

Therefore companies with qualified employees do their best in preserving them at any price. In July, the touristic market operators observed a demand increase in organizing corporate holidays. Therefore, the employees are reasoned to work more efficiently and this increases the labour productivity. At the same time, well organized corporate holidays make the employees faithful to their companies. Obviously only the biggest companies can afford such luxuries. A big part of small and medium businesses continue to face the risk of loosing their employees, due to their insignificant financial power.

## Budget

In January – July 2007 the national budget revenues constituted 142 million MDL, which is 2.3% higher than the planned level, accounting for the amendments to the Law on State Budget for 2007 from June 14, 2007. At the same time, in July the national budget received grants of 38.2 million MDL.

**Table 1 Dynamics of national public budget**

	Planned M1- M6/07	Executed M1- M6/07	Executed M1- M6/06
Global revenues, million MDL	9190,6	9906,8	7695,7
Including, revenues from VAT, million MDL	3186,3	3324,5	2492,3
Including, income taxes from business activity	633,4	843,7	572,2
Global expenditures, million MDL	11924	9954,8	7764,9

Source: Ministry of Finance

In July, the Parliament amended again the Law of State Budget, increasing the revenues to 13.06 milliard MDL and the expenditures to 13.13 milliard MDL. As a result of unfavorable climacteric conditions of this year, the expenditures were increased to the following positions: agriculture, the Ministry of Agriculture and Food Industry, the Subsidy Fund for Agricultural Producers. The analysis of national public budget in the first semester shows an execution of 107.8% on the revenue side, with a value of 9906.8 million MDL. On the other side, the expenditures were 9954.8 million MDL – only 83.5% from the planned level, due to the low allocation of resources to their destination. Thus, the education sector received 680.4 million less MDL (25.6% less) than the planned level. Also, less than 75% funding of the planned level received the external activity sector, justice, science and innovation, culture, art, sport and activities for youth. However, compared to previous months of the year, the executed expenditures are closer to the planned ones.

Through the Government Decision no. 756 from July 2nd, 2007 the 2008-2010 Medium Term Expenditure Framework of the Republic of Moldova was approved. It indicates an increase in the level of revenues until 2010 up to 26.8 milliard MDL and 2% annual increase of national public budget expenditures.

The document introduces important changes in the fiscal policy of the state. The zero tax on reinvested profit is introduced and only the distributed profit continues to be taxed at 15% rate. The triple scale of taxation of personal income will be replaced by the double scale. Thus, the income below 25200 MDL will be taxed at 7% rate and the income above this

level will be taxed at 18% rate, with the gradual increase of the value of income amenable to tax exemption. As a result, all the employees will benefit, but the middle-income class (income between 200 and 400 USD) is still affected. However, the benefits are not essential as, simultaneously, the contributions to the state social insurance budget will decrease to 28% in 2010, but increasing the rate paid by the employee to 8% and the decreasing the rate paid by the employer to 20%. Also, the mandatory medical insurance contribution will increase to 7% by 2010, equally paid by the employer and the employee (3.5+3.5). Thus, following all this changes we can expect the risk of employees becoming less motivated of tax return than the employers.

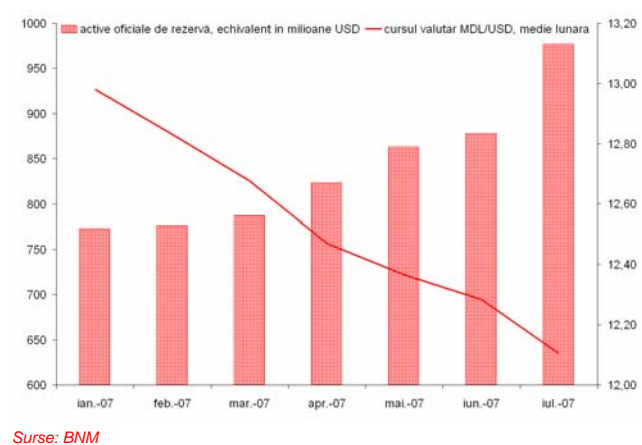
As a result, the social insurance budget and medical insurance budget will benefit the most. At the same time, the revenues of territorial-administrative units' budgets will decrease, meaning that an increase of transfers from state budget will be mandatory.

## Currency

As anticipated in the previous editions, the NBM Council of Administration did not modify the Bank monetary policy instruments during the meeting held in July 2007. The last essential modification was done in April, when the monetary authority diminished by 1.0 percentage point the base interest rate (REPO) and the interest rate to overnight credits. However, the result of those adjustments were minimal, as commercial banks reduced their interests for a short period of time that later, in May were considerably increased.

The position adopted by the NBM could be qualified as precautions. Indeed, compared to 2006, in the first part of the year 2007 the prices went up within the limits of NBM and the Government's forecasts, but there are risks of more striking short term increases in prices. A good part of agricultural harvest has been compromised by the drought and the lack of agricultural products and raw materials that have already been reflected into an essential increase in prices (wheat, bread, dairy products, vegetables and fruits). Another inflation source constitutes the increase in prices for electric energy and fuel that could be expected during this year. From the demand side, the risks of inflation could appear from the real increase of salaries and social contributions, as well as the increase of other incomes, mainly those received from working abroad.

**Figure 5 NBM official reserve assets, million USD and exchange rate USD/MDL**



The national currency appreciation, that can be constantly noticed from the beginning of this year, on the one side, serves to NBM purposes to control the inflation and increase its currency reserves. If in January the US dollar valued 12,99 MDL, at the beginning of August the US Dollar dropped by 12,04 MDL. Obviously such a decrease in the exchange rate was extremely favorable for filling in the NBM reserve assets. Moreover, the US dollar depreciation against other currencies determined the marking up of the NBM assets in third currencies. From the beginning of the year these essentially appreciated (+26%), reaching on August 3, the record level of 989 million MDL and lining out to the target level of 1 billion. (Fig.5)

On the other side, the national currency appreciation reduces even more the economic competitiveness and stimulates the demand for imported goods. Despite the fact that the official reserve assets grow in absolute expression, the situation on imports is not considerably improving. If in July 2006 the currency reserves were covering 2,8 imports months, in July 2007 these were covering 3,0 imports months.

It is important to mention that a considerable part of citizens' real income is outsourced from abroad currency transfers and salaries tied to exchange rate. Should this evolution continue on long term, the prices increase at the same time with the local currency appreciation, this would lead to one of the worst scenarios for the Moldovan economy.

The NBM financial report for the 1st semester was published in July. The report reflects a significant consolidation of assets and the bank capital and a registered substantial profit increase (242 million MDL, +40% against 2006).



## Banking System

In June the average interest rate at commercial banks of Moldova for the deposits in national currency was 15.49% and for those in foreign currency – 5.96%. The average lending rate for the loans in national currency was 18.98% and for those in foreign currency – 11.01%. The evolution of the average monthly interest rates for bank deposits and loans during the first semester of 2007 can be followed in figure 6, where a clear rise in deposit and lending interest rates for resources in national currency is observed.

**Figure 6 The evolution of interest rates, %**



Source: BNM

The total value of the loans offered by commercial banks in June was almost twice higher than in January and it reached the December level. Only in January the proportion of the loans in foreign currency exceeded 50% from the total amount, during the rest of the semester this proportion being between 38 and 48%. An obstacle in the positive evolution of the loans is the high lending rate, which increased during the second trimester. This tendency will dominate in the second semester too; as NBM is using a high interest rate in order keep inflation at low level. During the first semester the deposits in foreign currency constituted between 45 and 60% from the total amount.

The Deposit Guarantee Fund in the Banking System increased the resources warranting the deposits of private persons by 3 million MDL and reached more than 40 million MDL. However, this amount is still insignificant to be able to be a real guarantee for the bank deposits.

According to the situation at June 30, Moldova Agroindbank is still a leader in Moldovan banking system by the value of assets, loan and deposit portfolio (including deposits from private persons). For these categories in top 5 banks also are

included: Banca de Economii, Victoria Bank, Moldincombank and Mobiasbanca. But only Banca de Economii and Mobiasbanca from the previously mentioned rank in top 5 according to the liquidity, with a current liquidity of 59.97% and 35.72% accordingly.

The privatization process of Banca de Economii will start soon; at least this is the affirmation of the officials. The privatization of the bank is a condition imposed by FMI; the state should have decided on the time and way of privatization. Now, the state is the owner of 56.13% of the shares of the bank. The independent evaluation of the market value of the bank should be done until the end of the year, with the most optimistic forecast – end of September. The privatization in a transparent and competitive way can assure the entrance on the Moldovan banking system of a renowned bank.

## Financial Markets

After a slight growth in May, the interest of treasury bills started to drop in summer months. (Fig.7). The interest of bills with 91 days maturity decreased from 11,36% in May to 11,08% in July. The interests of bills with 182 and 364 days maturity dropped by 0,15 percentage points. This situation was determined by the commercial banks that maintained high quotas for financial titles issued by the Ministry of Finance. The rate of state obligations with 2 years currency term continued to grow, starting with April and reached the level of 13,24%. This reflects a certain decrease in banks' interest for relatively long term investments.

In June – July the US dollar tendency to depreciate against MDL has intensified. From 12,39 MDL/USD at the beginning of June, the exchange rate reached 12,27 at the beginning of July and by August 1, accounted 12,20. The factors that led to MDL appreciation were the inflows of foreign currency from physical entities and more significant foreign investments. At the same time, Moldova received several installments of external credits that influenced the situation on the currency market. Several signs that encouraged the MDL appreciation came even from Russia, where the Ruble constantly and significantly appreciated during 2007. The ratio MDL-RUB did not essentially change in this period and this created profitable opportunities for currency speculations. Despite commercial hindrances, Russia is the main commercial partner for Moldova and the evolutions on Russian markets are able to greatly influence our currency market.



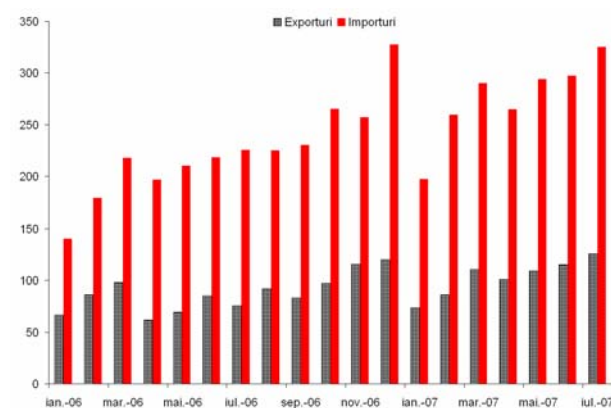
As important news of this month, one can refer to leasing services. Raiffeisen Leasing Romania will become, at the end of this year, the only shareholder of Raiffeisen Leasing Ltd. that will be open on Moldovan market. Leasing services will be offered for automobiles, trucks, vehicles, as well as different hardware and equipment.

The local market of leasing services is still at beginning phase, as those 11 companies working in the sector are not connected to international financial institutions, and the supervisory mechanism has only started to function. The appearance of the new actor will encourage the leasing services market to boost its development pulse.

## Foreign Trade

The foreign trade of the Republic of Moldova was marked off by several important tendencies in the first semester of 2007. On the one hand the imports continue to grow more rapidly than exports (+38% and +27,6%, respectively, see Fig.7), but the commercial deficit reached 1007,3 ml. USD at the end of June, with 45% more than last year.

**Figure 7 Evolution of exports and imports, million USD, discrete data by month**



Source: NBM

On the other hand, our exports undergo through profound restructure both from the point of view of directions of destination and the categories of exported goods.

Therefore the European Union has become the main destination of Moldovan exports (50,4% out of total export). Simultaneously this evolution took place both because of the increase of the volume of export products on community market, and the decrease of exports to CIS countries (the lion's share in this decrease belongs to the Russian Federation, which

in March 2006 introduced the embargo on Moldovan wines).

The geographical reorientation of exports has determined considerable modifications of different export products ratio. Thus "the food products, drinks and tobacco" have lost their leading ratio in the total of export products, yielding to textile as the main Moldovan export on community market. The relatively highest rise was achieved by "base metals and manufactured out of them articles", reflecting the confluence of several factors: the increase of export volumes, joining of Romania to EU and official export of Ribnita plant to the competent authorities of RM. The export decrease of food products seems to be a long-term trend. First of all, the eventual resumption of Moldovan wines export to the Russian Federation market (see below) will not mean the reinstatement of previously gained segments of market, but most likely will indicate limited effects on the volume of exported wine, at least for a near term outlook. Secondly, the agricultural products in the nearest future will become "persona non-grata" on the community market, both due to the glut of local products and also because of quality problems and certification of Moldovan products. Symptomatically, the Republic of Moldova cannot distinguish itself in achieving progress of adjusting its products to the European standards. The eventual provision of Autonomic Commercial Privileges will not mean the automatic removal of these deficiencies from the commerce with EU.

In the context of expansion of Moldovan exports on EU market an important role is undertaken by the commercial relations with Romania. The joining of Romania to the EU has not dramatically influenced on Moldovan exports, which rose by 42,9%, comfortably ranking the second place after the Russian Federation in the first semester of 2007. And vice-versa, some Romanian exports were seriously affected by the abolishment of free commercial regime between our countries. The considerable share of our import consists of mineral and fuel resources, but the food products seem to be considerably reduced due to non-competitiveness with local products, as well as products with Russia and especially from Ukraine. The joining of Romania to the EU seems to have affected the operations of multinational companies from the region. The latter prefer to bring products in Moldova from Ukraine and Russia, instead of Romania.

Apparently there is a progress on the "sensible" issue of Moldovan wines export to Russian market. Lately,

several more optimistic perspectives became notable. Most probably those wine-making companies will not be discriminated on their capital's origin (Russian or non-Russian) or by geographical location of enterprise (left or right side of the Dniester). At the same time, the ways of conducting export activities are covered by uncertainty. The lack of transparency on this matter makes us consider, that the recurrence of Moldovan wines on Russian market will take more time than most optimists assume. Thus paraphrasing the classics one can say in order not to get disappointed it is better not to deceive yourself.

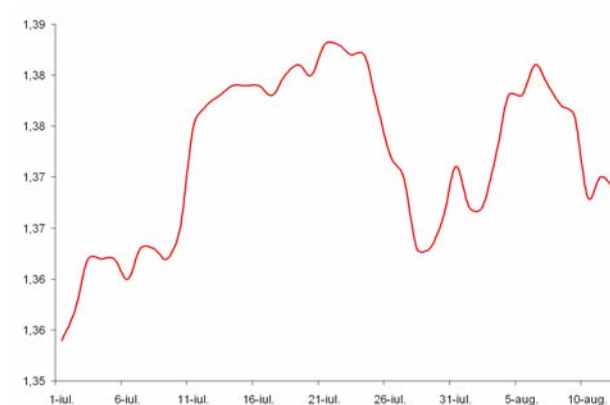
## World Market

The July month was marked off by a pronounced increase in **petrol** prices. This trend was strong especially in the first half of the month, when the petrol price of Brent mark has surpassed the level of 78 USD/barrel, the highest one from August 2006. By the end of July the price has undergone through corrections on the market, but did not exceed the level of 75 USD/barrel. Compared to the last year's summer evolution, which was mostly simulated by geopolitical risks, the actual rise is based on purely economic factors, which is bigger consumption of petrol by USA and South-Eastern Asia. Thus the latest estimations of the International Agency for Energy show an annual increase of consumption by 2,2% during the period of 2007-2012, significantly more than anticipated. It is necessary to mention that these estimations are based on the optimistic forecasts of actual global economic growth intact by rising fuel price. By the end of month even OPEC has expressed its concerns regarding the excessive rise of petrol price, gaining over an average price between 60-65 USD/barrel. At the same time the OPEC position remains confusing: on one hand the leaders of this organization are alarmed by the fact that too expensive petrol can have negative effects on global economic growth perspectives. On the other hand they withhold to increase the manufacture of petrol appealing that the fuel stocks in developed countries is remaining big and this proves the sufficiency of global supply. The next meeting of OPEC in the beginning of September shall clarify the position of this organization. Nevertheless for the near-term outlook the price of petrol will remain high<sup>5</sup>.

The forecast regarding **the wheat crop** for 07/08 continues to be negatively affected by unfavourable weather conditions (particularly unbearable heat) in

the South-Eastern Europe and in Canada. In Europe, the price on wheat has reached the record level of more than 200 Euro/tonne. At the same time the situation in Kazakhstan, China and India is better, which allows to estimate that the global wheat harvest will remain the same at 614 ml. tonnes, which is 21 ml. tonnes more than in 2006. Yet the global annual consumption is decreased by 2 ml. tonnes due to the consumption fall in EU. Even though the global stocks are being increased by 1 ml. tone up till 112 ml. tonnes, they still remain at the lowest level in the last 28 years. A quite tense situation remains on the **barley** market, where the setting up of quota for export by Ukraine has decreased significantly the supply on market. Only the expectations on better barley crops in Australia will lighten the situation by the end of the year<sup>6</sup>.

**Figure 8 Evolution of exchange rate USD/EUR**



Source: Rosbusinessconsulting

In general, July 2007 was characterized by the **USD** depreciation against **Euro** (Figure 7). This trend was mainly determined by the bad financial situation on the real-estate market and the weak growth of American economy. In the first half of July Euro has tested and remained at the level of 1,38 USD/EUR.

In the second half of the month the dollar rate has adjusted a bit, varying between 1,36-1,37 USD/EUR. This was supported by the decrease of commercial deficit and improved expectations on the level of employment in American economy. In addition, considerable volatility observed at global market provided additional support to American currency, which is traditionally seen as firm investments during the turbulent market.

<sup>5</sup> Source: The Economist, International Energy Agency, Reuters, RBC.

<sup>6</sup> Source: USDA, World Agricultural Supply and Demand Estimates, Wheat Outlook; International Grains Council, Grain Market Report.

However at the beginning of August the pessimism related to forecasts in American economy has become omnipresent and the majority of economists have acknowledged the fact that the difficult situation at real-estate market has negative consequences over the other sectors of the American economy.

The data related to unemployment rate and industrial production as well has underscored this issue. Presently several estimations indicate the possibility of recession of American economy due to the deterioration of situation at real-estate market.

On the other hand, the European economy continues to benefit from quite good trends and Central European Bank is willing to increase the interest in September. Hence, the rate of 1.4 USD/EUR by the end of this year is quite possible, according to the analytic experts' opinion<sup>7</sup>.

## Trade Partners

In the first half of the year 2007 the **Russian** economy intensively grew with 7,8% compared to the same period of 2006. This robust growth was supported by a strong investment demand (+22,3%), dynamic extension of the construction sector (+25,5%) and industry (+7,7). It is worth mentioning that during this period the quick expansion of the construction sector contributed to the development of the line industries: cement (+20,7%), glass (+46%), etc. The consumption also led to economic development, being supported by the population available real income and real salaries that were increased by 11,2% and 17,5%, respectively. The strength of the current consumption contributed to the development of trade in detail (+14,2%). The exports continued to grow moderately (11,6%).

Among other evolutions we can mention one that could affect the European energetic security: the Gazprom appointment of the French company "Total" as partner in developing Stockman deposits. However, it is likely that this decision remains valid only in case Russia succeeds to impede the attempts of adoption of the new European regulations that would even the EU member states positions in the field of energy<sup>8</sup>.

In the first semester of 2007 the Ukrainian economy maintained high growth rhythms: +7,9% against the same period in 2006. Simultaneously to the growth of private consumption (+28,6%) and exports (+34,4%), an important contribution belongs to the agriculture

(+6,3%). The growth of the agricultural sector after several months of stagnation is explained by the drought and early harvest of cereal. Therefore, the agriculture contribution to the GDP will be modest in the next months. The quick economic development made more experts review their annual forecasts on economic growth from 6,5% to 7,5-8%. At the same time, these positive forecasts are based on the assumption that several important risks are avoided: the aggravation of the political situation, deterioration of the favorable conjuncture of the global prices for steel and chemical products, quick growth of prices for imported natural gases, sudden US dollar depreciation, etc.<sup>9</sup>.

**Table 3. Economic Indicators of Moldovan main trade partners**

	GDP		Industrial production	Inflation	Unemployment
	Recent data	2007, forecast			
Russia	7,8 S1/07	6,3	7,7 S1/07	5,7 S1/07	6,7 06/2007
Ukraine	7,9 S1/07	7,5	11,8 S1/07	5,6 01-07/07	8,0 T1/2007
Romania	6,0 T1/2007	6,5	6,1 S1/07	3,9 06/07	7,3 06/07
Germany	3,6 T1/06	2,2	5,1 05/07	2,0 06/07	6,4 06/07
Italy	2,3 T1/07	1,7	0,9 05/07	1,9 06/07	6,2 T1, 2007

Sources: The Economist, IMF, World bank, Derjkomstat, Goskomstat, Eurostat, INS Romania, EXPERT-GRUP

The **European Union** economy continues to grow firmly. The development is first supported by the internal demand and investments and the external demand for the European products. It is worth mentioning that Euro appreciation still has limited effects on demand. The trade surplus of euro zone constituted 1,7 billion Euro in May. Not surprisingly that the producers and consumers' great confidence is translated into quick industrial growth, higher corporate investments, more employment opportunities, and stronger private consumption. The inflation is under control (1,8%<sup>10</sup>), this allowed the Central European Bank not to increase the interest rate in July. However, more experts believe this step will be made in September. The positive trend in the industry development will be maintained in the nearest future, as the industry requests in Euro

<sup>9</sup> Інститут економічних досліджень (Institute for Economic Research and Policy Consulting), Міжнародний центр перспективних досліджень (International Centre for Policy Studies), Експерт-Україна (Expert-Ukraine).

<sup>10</sup> The target of stable inflation, BCE is 2%.

<sup>7</sup> Reuters, RBC, Global Insight Inc., The World Bank.

<sup>8</sup> Інститут Економіки Переходного Періода.

zone show (+1,7% in June 2007 against the previous month).<sup>11</sup>

The **Romanian** economy experienced a high growth in the 1st semester of 2007. The growth is supported by positive dynamics in industry (+6,1%, with a weakness in the positive trend registered in June due to the decrease in the processing industry), construction (+28,7% in June 2007 against the previous month of 2006), trade en detail (+9,6%) and services (+0,4%). Consecutively, managers' expectations regarding the evolution from July-September are positive for all the major Romanian economy sectors: industry, construction, trade en detail, and services, although new employment perspectives in industry are limited.

The tendency of developing the capitals allotted by the regional investment funds to Romania should also be mentioned. These increased from 60,5 million Euro in 2005 up to 283 billion Euro in 2006. The money is used for companies' exclusive development. Taking into account that these investments are mainly directed towards the growing sectors and companies, the managers and the successful companies easily access financial resources needed for business development. Many Romanian experts anticipate the positive maintenance of this trend in the following years<sup>12</sup>.



<sup>11</sup> Eurostat, The Economist, RBC, Global Insight Inc.

<sup>12</sup> Sources: Financial Week, The Capital, Curentul, The Economist.